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NEW YORK BUSINESS CORPORATION LAW: ARTICLE 5— CORPORATE FINANCE

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THE topic of corporate finance is generally regarded as one of the two or three crucial elements in any corporation law, and one on which a good deal of heated controversy can be generated. It is a subject that brings into sharp focus basic differences in point of view, from an extreme confidence in administrative regulation to an equally extreme faith in the "enabling act" principle of statutory drafting.

The financial provisions of the new Business Corporation Law of New York cannot be classified at either extreme. In the main they combine features of the predecessor statute, the Stock Corporation Law, and of the American Bar Association's Model Business Corporation Act;[1] but they also reflect the impact of the laws of California, Delaware, North Carolina, Ohio, Pennsylvania, and perhaps other states, as well as a few original ideas evolved in the process of attempting to produce a modern, coherent and workable statute.

Some months ago, one of my students and I undertook to review the financial provisions of the new law, with particular attention to their sources and their history during nearly five years of development.[2] My purpose in this paper is to analyze these financial provisions largely in the light of the critical commentary they have received in the ten months following their enactment. Whenever relevant, mention is made of the provisions of the omnibus amending bill introduced in the legislature in March 1962.[3]

I

CORPORATE SECURITIES

The Business Corporation Law makes two dramatic innovations in the law governing bonds and shares: one is the authorization for granting voting rights to bondholders;[4] the other is the achievement of full limitation of liability

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1. The American Bar Foundation's three-volume work, The Model Business Corporation Act Annotated (1960) should be a valuable source of information concerning the probable interpretation of those sections of the new Business Corporation Law of New York which have been derived from the ABA-ALI Model Bus. Corp. Act (1959 rev. ed.) [hereinafter referred to as Model Act].

2. De Capriles & McAniff, The Financial Provisions of the New (1961) New York Business Corporation Law, 36 N.Y.U.L. Rev. 1239 (1961).

3. Omnibus amending bill introduced in Senate, March 8, 1962; S. Int. 3774, S. Pr. 4287, 185th Sess., (1962) [referred to hereinafter as omnibus bill]. This bill incorporates a number of amendments proposed in separate bills during January and February, 1962.

4. N.Y. Bus. Corp. Law § 518(b). See Rohrlich, New York's Proposed Business Corporation Law, 15 Record of N.Y.C.B.A. 309 (1960); Anderson & Lesher, The New Business Corporation Law, 33 N.Y.S.B.J. 308 (1961).

for shareholders in public-issue corporations.[5] Also new is the authority given to directors to allocate to surplus a portion of the consideration received for shares without par value,[6] and to issue certificates for fractions of shares.[7]

The statute expands the power of directors to act without shareholder approval in the issue of secured and convertible bonds,[8] as well as to reduce stated capital in situations which involve a reversal of action previously taken by the board.[9] Some restrictions are placed on convertible shares.[10]

Other new provisions are designed to improve the rules governing subscriptions[11] and to facilitate the issue of rights and options to directors and officers.[12] All of these have controversial aspects which will now be examined.

Bonds—The basic idea of granting voting rights to bondholders, derived from the law of at least three states,[13] seems to have some practical merit. However, the pertinent section provides for the right "to vote in respect of the affairs and management of the corporation and any other rights which shareholders may have."[14] This language seems too broad. The 1962 omnibus bill would limit these voting rights to the election of directors and other matters on which shareholders may vote.[15]

The elimination of shareholder consent, in the absence of an appropriate certificate provision, for the mortgage or pledge of corporate assets[16] has been severely criticized.[17] However, the power to give security seems inseparable from the power to borrow money, which is normally vested in the directors.[18]

With respect to bonds convertible into shares, a corporation is given the option either to reserve enough unissued shares to satisfy conversion privileges or to authorize the directors, by certificate provision, to file amendments increasing the number of authorized shares up to a specified limit to satisfy conversion privileges.[19] Accordingly, specific shareholder approval is no longer necessary for the issue of convertible bonds. The logic is this: If there are enough unissued shares, the directors normally have sole authority to issue

5. N.Y. Bus. Corp. Law § 630. Cf. N.Y Stock Corp. Law § 71.
6. N.Y. Bus. Corp. Law § 506(b). Cf. Model Act § 19.
7. N.Y. Bus. Corp. Law § 509(a). Cf. Model Act § 22.
8. N.Y. Bus. Corp. Law §§ 911, 519. Cf. N.Y. Stock Corp. Law § 16(1).
9. N.Y. Bus. Corp. Law § 516, adapted from Model Act § 63. Cf. N.Y. Stock Corp. Law § 35(4)(a).
10. N.Y. Bus. Corp. Law § 519(a),(e). Cf. N.Y. Stock Corp. Law § 27.
11. N.Y. Bus. Corp. Law § 503. Cf. Model Act § 16.
12. N.Y. Bus. Corp. Law § 505. Cf. Model Act § 18A.
13. See Cal. Corp. Code § 306; Del. Code Ann. tit. 8, § 221 (1953); Md. Ann. Code art. 23, § 18(a)(8) (1957).
14. N.Y. Bus. Corp. Law § 518(b).
15. Omnibus Bill § 25.
16. N.Y. Bus. Corp. Law § 911.
17. Kessler, The New York Business Corporation Law, 36 St. John's L. Rev. 1, 25-26 (1961).
18. A combination of the power of the corporation to borrow, etc. (N.Y. Bus. Corp. Law § 202(7)) and the power of the directors to manage (N.Y. Bus. Corp. Law 701).
19. N.Y. Bus. Corp. Law § 519(d)(2), basically following N.Y. Stock Corp. Law § 16(2). The omnibus bill in Section 26 would substantially amend the language of this section to correct an oversight in making similar provision for shares convertible into other shares, but would not change the provisions governing convertible bonds.

them, just as they have sole authority to issue non-convertible bonds. Thus, there is no reason to deprive them of the authority to issue bonds which are convertible into the same shares that they have sole discretion to issue. If, on the other hand, there are not enough unissued shares, the approval given by shareholders to the certificate provision, permitting the filing of amendments in the number of authorized shares up to a specified limit, obviates the need of further approval for the issue of bonds convertible into such shares.

Shares, Capital and Surplus—In some respects, the most controversial provision on Corporate Finance in the new statute does not appear in Article 5. This is the section[20] that retains the principle of Section 71 of the Stock Corporation Law for unlimited liability of shareholders for wages and fringe benefits owed to employees, but limits its application to the ten largest shareholders of corporations, the shares of which are not listed on the national exchanges or regularly traded in the over-the-counter market.[21]

The modernization of the law of New York on the subject of shares without par value follows the Model Act.[22] It is controversial mostly on the point whether it is desirable to allow a period of sixty days within which the directors may decide what portion of the consideration shall be stated capital and what portion capital surplus.[23]

It may be worth mentioning here that the omnibus amending bill eliminates the reference to "capital surplus" in this and a related section,[24] so that the consideration received by the corporation in excess of the stated capital represented by par and no-par shares will be assigned simply to "surplus," without further specification.[25] The reason for the amendment is to remove a possible inconsistency with a later section[26] which, at least by implication, permits the carrying forward of the combined "earned surplus" of several corporations, following a "pooling of interests," even though the legal form of combination may involve the issue of the shares of a new or surviving old corporation.[27]

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20. N.Y. Bus. Corp. Law § 630.

21. Although this anachronistic section offends against the theoretical symmetry of the new Act, there is a good deal of practical justification for it. The problem is that undercapitalized corporations in certain industries all too frequently go bankrupt suddenly without paying their wage-earners, who have no effective means of protecting their claims. The large public issue corporations, on the other hand, are seldom liquidated, and the normal priorities given to wage-earners are sufficient protection for their claims.

22. Model Act § 19. This replaces the anomalous provision for two kinds of no-par shares: those with a minimum stated value (Type A) and those in which the entire consideration is allocated to stated capital (Type B). N.Y. Stock Corp. Law § 12(4).

23. N.Y. Bus. Corp. Law § 506(b).

24. N.Y. Bus. Corp. Law § 102(a)(12) [definition of "stated capital"].

25. Omnibus Bill §§ 1, 16.

26. N.Y. Bus. Corp. Law § 517(a)(1)(B).

27. "For accounting purposes, the distinction between a *purchase* and a *pooling of interests* is to be found in the attendant circumstances rather than in the designation of the transaction according to its legal form." American Institute of Certified Public Accountants, Accounting Research & Terminology Bulletins (Final ed. 1961), Accounting Research Bull. No. 48, at 21. See Baker, Dividends of Combined Corporations: Some Problems under Accounting Research Bulletin No. 48, 72 Harv. L. Rev. 494 (1959).

The introduction of this amendment has caused some alarm among accountants,[28] who fear that its enactment may be construed as approval of a credit to earned surplus for consideration received in excess of stated capital when no pooling of interests is involved. The definition of "earned surplus," however, would seem to preclude any real possibility of such construction.[29]

The new statutory permission for the issue, at the option of the corporation, of certificates for fractions of shares[30] is another provision derived from the Model Act.[31] Its language has been criticized because it does not clearly limit the issue of fractions of shares to the specific situations in which the idea is useful: transfers requiring the division of whole shares, share "dividends," splits or reclassifications, mergers, etc. The fear has been expressed that a corporation may issue all of its shares originally as fractions[32] in order to take advantage of a later section that permits redemption of fractions of shares out of capital.[33]

The new statute permits directors to reduce stated capital without shareholder approval in three situations: (1) the cancellation of reacquired shares,[34] which is a reversal of the issue of those shares by the directors; (2) the reduction of the amount allocated to stated capital out of the consideration received for shares without par value,[35] which is a revision of the allocation made by the directors at the time of issue of no-par shares; and (3) the transfer back, from stated capital to surplus, of any amounts previously transferred from surplus to stated capital by the directors.[36] The last two are subject to a limitation protecting the liquidation preferences of no-par shares and the par value of other shares.[37]

Disclosure of these reductions of capital is made directly to the shareholders,[38] rather than by the filing of a pseudo-"amendment" of the certificate of incorporation in Albany as provided in the Stock Corporation Law.[39]

The issue of convertible shares is limited in two respects: There is a prohibition against "upstream" conversion into securities of higher rank,[40]

28. Testimony of Mr. Miles L. Lasser on behalf of the American Institute of Certified Public Accountants at public hearing in Albany, February 14, 1962.

29. N.Y. Bus. Corp. Law § 102(a)(6) defines earned surplus in terms of retained earnings; thus, it would not include capital contributed by shareholders in excess of stated capital. The earned surplus of the surviving corporation in a pooling of interests represents the combined retained earnings of the component corporations.

30. N.Y. Bus. Corp. Law § 509(a).

31. Model Act § 22.

32. Testimony of Abraham N. Davis, Department of State (Section 19) at public hearing in Albany, February 14, 1962. The omnibus bill would permit fractions of shares only "where necessary to effect share transfers, share distributions or reclassifications, mergers, consolidations or reorganizations . . . ."

33. N.Y. Bus. Corp. Law § 513(b)(1).

34. N.Y. Bus. Corp. Law § 515(b),(d).

35. N.Y. Bus. Corp. Law § 516(a). Cf. N.Y. Bus. Corp. Law § 506(b).

36. N.Y. Bus. Corp. Law § 515(a). Cf. N.Y. Bus. Corp. Law § 506(c).

37. N.Y. Bus. Corp. Law § 516(b).

38. N.Y. Bus. Corp. Law §§ 515(d), 516(c).

39. N.Y. Stock Corp. Law §§ 35, 36. Cf. Model Act § 63.

40. N.Y. Bus. Corp. Law § 519(a). Cf. Model Act § 14(e).

designed to avoid provisions that would allow a shareholder to move into a protected position in the event of corporate adversity; and there is a prohibition against giving the corporation the right to exercise the conversion privilege,[41] since this would in effect be a misleading label for a form of redemption. When shares are converted, the new method of public disclosure of the fact and effect of conversion[42] is similar to that followed for capital reduction,[43] although the new statute (retaining the policy of the Stock Corporation Law)[44] prohibits reduction of capital upon conversion of shares.[45]

Subscriptions—Among the non-controversial improvements made by the new act on subscriptions and other matters connected with the issue of shares are the provisions requiring a writing for enforceable subscriptions,[46] making pre-incorporation subscriptions irrevocable for three months,[47] prescribing that calls on unpaid subscriptions be uniform as to all shares of the same class or series,[48] and generally clarifying the consideration to be given in payment for the shares.[49]

There has been disagreement, however, about the practicability of merging the Stock Corporation Law's provision for forfeiture of defaulted subscriptions and of previous payments thereon[50] with the Model Act provisions for other penalties, as defined in the by-laws, and for optional sale of the shares in the event of forfeiture,[51] without specification as to which rules are applicable in particular cases. The omnibus amending bill[52] attempts to resolve this question through an adaptation of language found in the law of Ohio[53] and the Uniform Conditional Sales Act.[54]

Rights and Options—Under the new act, the rules governing rights and options to purchase shares differ according to whether such rights are exercis-

41. N.Y. Bus. Corp. Law § 519(a). Cf. N.Y. Stock Corp. Law § 27 (shares convertible at the option of the holder only).

42. N.Y. Bus. Corp. Law § 519(f). The language of this section does not adequately cover the situation where shares are converted at frequent intervals during a period of time. The omnibus bill (Section 26) would remedy this deficiency.

43. N.Y. Bus. Corp. Law § 515(d).

44. N.Y. Stock Corp. Law § 27(4).

45. N.Y. Bus. Corp. Law § 519(c).

46. N.Y. Bus. Corp. Law § 503(b). Cf. N.C. Gen. Stat. § 55-43(b) (1960).

47. N.Y. Bus. Corp. Law § 173(a), adapted from Model Act § 16.

48. N.Y. Bus. Corp. Law § 503(c).

49. N.Y. Bus. Corp. Law § 504. Cf. N.Y. Stock Corp. Law § 69.

50. N.Y. Stock Corp. Law § 68.

51. Model Act § 16.

52. Omnibus bill § 12.

53. Ohio Revised Code § 1701.20(B) (Supp. 1961). Cf. an early Pennsylvania provision (Pa. Stat. Ann. tit. 15, §§ 132, 1592) superseded in 1933 by Section 604 of the Pa. Bus. Corp. Law which provides for a lien instead of forfeiture and sale. (Pa. Stat. Ann. tit. 15, §§ 2852-604).

54. Cf. N.Y. Pers. Prop. Law §§ 60-81-b (Uniform Conditional Sales Act) at § 79 (provision for compulsory public resale of repossessed goods if more than fifty per cent of purchase price has been paid). The omnibus amending bill, however, does not require a public sale in order to avoid possible complications under the Securities Exchange Act of 1934 on the question of registration.

able by directors, officers or employees, or by others; and according to whether the options are granted pursuant to a plan or not.

Shareholder approval is still required for those options that are granted, pursuant to a plan or not, to directors, officers or employees.[55] However, the new statute facilitates this form of incentive compensation in two ways: first, the right of dissenting shareholders to receive payment for their shares has been eliminated;[56] and, second, if the shares to which such options pertain are subject to preemptive rights, approval of the granting of the options by a majority of the shares entitled to exercise preemptive rights is binding upon the minority.[57]

Considerable latitude is expressly allowed in the terms and conditions under which options to directors, officers and employees are granted pursuant to a plan approved by shareholders, including permission to issue certificates for partly paid shares (not otherwise available under the new act)[58] and to give flexible voting and dividend rights to such partly paid shares (not available on options not issued under a plan).[59] The provisions on partly paid shares were urged by the organized bar on the ground—that, otherwise, confusion could result under employee share-purchase plans heretofore adopted in the state.[60] It should be noted, however, that the new provisions are probably broader on voting, dividend and liquidation rights of partly paid shares than permitted by the Stock Corporation Law,[61] and that there is no requirement that the amount still due appear plainly on any certificate issued for partly paid shares.[62] There has been additional pressure from the organized bar for a "grandfather clause" on the validity of existing plans, for abandonment of distinctions based upon whether options are issued to directors, officers or employees pursuant to a plan, and for a broad grant of authority to directors to adminster stock option plans after shareholder approval of specified basic terms of such plans,[63] but these views are not reflected in the omnibus amending bill.

55. N.Y. Bus. Corp. Law § 505. Cf. N.Y. Stock Corp. Law § 14.

56. Cf. N.Y. Stock Corp. Law § 14.

57. N.Y. Bus. Corp. Law § 505(d). This is the general approach followed in California, Cal. Corp. Code § 1108, and Pennsylvania, Pa. Stat. Ann. tit. 15, § 2852-612 (1958).

58. N.Y. Bus. Corp. Law § 504(h).

59. N.Y. Bus. Corp. Law § 505(f).

60. Committee on Corporation Law, N.Y. State Bar Ass'n & Committee on Corporate Law, Ass'n of the Bar of the City of New York, Joint Report on Proposed New York Business Corporation Law, reprinted in 84 Report of New York State Bar Ass'n § 107, 115 § 5.04 [hereinafter cited as Joint Report of Bar Ass'ns].

61. Under N.Y. Stock Corp. Law § 74, if partly paid shares are properly issued, the corporation may declare and pay dividends "upon the basis of the amount actually paid upon the respective shares." It is extremely doubtful that the enactment of Section 14 authorizing installment payments for stock issued to employees, without specific limitations on dividend rights, was intended to amend Section 74, since the two sections can readily be reconciled.

62. Cf. N.Y. Pers. Prop. Law §§ 162-185 (Uniform Stock Transfer Act), particularly § 176 (no lien upon shares in favor of corporation unless the certificate contains notice of the lien).

63. Testimony of Messrs. Covington Hardee, Sinclair Hatch and Matthew G. Herold, Jr. at public hearing in Albany, February 14, 1962.

II

CASH DIVIDENDS

The Business Corporation Law's approach to cash and property dividends[64] involves three elements which synthesize relevant provisions of the Stock Corporation Law and the Model Act:

(1) The principle that no dividend in cash or property may be paid to the shareholders if the corporation is unable or would thereby become unable to pay its debts as they mature in the ordinary course of business;[65]

(2) The traditional New York view that dividends may be lawfully paid out of any surplus, including unrealized appreciation of assets,[66] modified by a new provision in favor of wasting asset corporations;[67] and

(3) The requirement that shareholders must be notified as to the amount and source of any dividend which is not paid out of accumulated net profits or "earned surplus."[68]

The interplay of the three major elements has been the subject of considerable comment since the enactment of the new law and will accordingly be discussed here before the new wasting assets exception, which has apparently won general acceptance.

The test of equitable solvency—It would seem self-evident that an implied, if not express, prohibition against the distribution of corporate cash or property to shareholders, when the corporation cannot pay its debts as they mature, should be an absolute condition of the granting of limited liability to shareholders. As a matter of fact, the test of equitable solvency for lawful dividends can by itself provide a reasonable measure of protection for short-term corporate creditors,[69] while the capital-impairment test will not, without at least an implied equitable solvency restriction.[70] Nevertheless, the inclusion of an express provision to this effect in the new law has elicited numerous expressions of disquietude among the lawyers of New York.[71]

At various times it has been suggested (probably erroneously) that the express provision changes the law of the state,[72] and that equitable insolvency is a rather uncertain limitation on the legality of dividends as compared, for

64. N.Y. Bus. Corp. Law § 510.
65. Cf. Model Act §§ 40, 41.
66. Cf. N.Y. Stock Corp. Law § 58; Model Act § 40(b).
67. N.Y. Bus. Corp. Law § 510(b).
68. Cf. Model Act § 41 (Distributions from Capital Surplus).
69. Cf. Mass. G. L. c. 156, §§ 35, 37 (1932). See Dodd and Baker, Cases and Materials on Corporations 945-963 (2d ed. 1951).
70. It is of course possible for a corporation to have an ample surplus and yet be unable to pay its debts as they mature because it has insufficient "equity" capital or because its assets are "frozen," i.e., not readily convertible into cash. Equitable insolvency may precipitate legal proceedings by creditors and pressure to liquidate assets at heavy loss that may lead to bankruptcy.
71. Joint Report of Bar Ass'ns, supra note 60 at 109, § 1.02.
72. Cf. Tierney v. J. C. Dowd § Co., 238 N.Y. 282, 144 N.E. 583 (1924), construing the equitable solvency provisions of N.Y. Stock Corp. Law § 15 to apply only to indebtedness embodied in a formal writing.

example, with capital impairment.[73] These views suggest another possible explanation: that the provision makes lawyers uncomfortable because it *seems* to demand a greater familiarity with business operations and financial analysis on the part of the legal adviser of a corporation than has generally been deemed necessary in the past.

Actually the express provision serves a dual useful purpose: to warn directors, who may declare dividends without advice of counsel, against improvident action even though the corporation has an accounting surplus;[74] and to remind the lawyer that a business adviser should have a modicum of elementary financial knowledge.[75] Lest there be undue alarm among our brethren at the bar, I may point out that the basic information for the determination of current equitable solvency is, as a rule, readily available to corporate management in the form of weekly, monthly, or quarterly cash projections or cash budgets.[76]

The surplus test—At first glance it may appear that the Business Corporation Law, in permitting dividends out of "surplus,"[77] defined as the difference between "net assets" (*i.e.*, assets minus liabilities) and "stated capital,"[78] merely recasts the provision of the Stock Corporation Law that forbids dividends by a corporation "unless the value of its assets remaining" after such dividends equals the "liabilities including capital."[79] However, it should be noted that the new statute, following the Model Act,[80] does not mention the word "value" in connection with the measure of assets, and that this *may* import an interesting change in the theoretical basis of computing the amount available for dividends.

The Stock Corporation Law has been interpreted to mean that the directors must "make a determination of the value of the assets at each dividend declaration."[81] This requirement places an undue and unnecessary burden on

73. This view, expressed by lawyers at several public hearings, involves an unrealistic optimism as to the degree of certainty that may be reached in the computation of asset figures, which in turn control the amount of surplus. The meaning of equitable solvency is well settled. See, e.g., Brouwer v. Harback, 9 N.Y. 589, 594-595 (1854). See also Black, Law Dictionary 938 (4th ed. 1951); 2 Bouvier, Law Dictionary 16-2-1603 (Rawle's ed. 1914), and cases and authorities cited therein. Cf. Kehl, Corporate Dividends 12-13, 33, 37 (1941).

74. N.Y. Legis. Doc. No. 12, Explanatory Memorandum (Appendix C) 63 (1961).

75. The lamentable vacuum in the education of many lawyers and law students can be filled in a few hours of study, assuming a working knowledge of accounting.

76. Essentially the cash projection shows the payments that have to be made for various reasons during the period and the sources of funds for such payments, including collection of receivables and borrowing (short-term or long-term), or additional equity investment in appropriate instances. The traditional financial statements (balance sheet and income statement), though relevant at long range, do not usually provide the necessary information on current solvency.

77. N.Y. Bus. Corp. Law § 510(a)(1), to be renumbered § 510(b) upon enactment of omnibus bill § 20.

78. N.Y. Bus. Corp. Law § 102(a)(9) and (12).

79. N.Y. Stock Corp. Law § 58.

80. Model Act § 2(i).

81. Walter J., in Randall v. Bailey, 23 N.Y.S.2d 173, 184 (Sup. Ct. 1940), aff'd mem., 262 App. Div. 844, 29 N.Y.S.2d 512 (1st Dep't 1941), aff'd, 288 N.Y. 280, 43 N.E.2d 43 (1942).

directors.[82] The intent of the new act is to avoid "any construction that would require appraisal of assets rather than reliance on ordinary accounting figures for computations of surplus. . . ."[83] This interpretation is confirmed by the protection afforded directors who rely in good faith upon financial statements.[84] In modern accounting, the statement of assets, liabilities, capital and surplus, is subordinated to the orderly computation of periodic profits and losses. The "value" of an enterprise is more accurately measured by its ability to produce income than by the aggregate of conventional "values" assigned to some of its property holdings.[85] Without developing the point further, because it would require more space than is here available, one may suggest that the acceptance of accounting figures for assets is a drastic (albeit eminently correct) departure from the standard established by the aforementioned construction of the Stock Corporation Law.

Yet in practice it seems clear that, except in the most unusual case, the new law will make no difference in the method of determining the amount of surplus available for dividends. It is submitted that directors, under the Stock Corporation Law, have generally relied upon financial statements and upon the accountants' figures of assets and surplus. Since the issue does not appear to have been raised in recent litigation, it may be assumed that the old act has not precluded the use of the conventional "values" assigned to assets in the modern balance sheet.[86]

But what about unrealized appreciation of assets? The new statute eliminates this figure from the computation of earned surplus;[87] it places no bar to its inclusion in capital surplus. Since the Business Corporation Law permits dividends to be paid out of *any* surplus, there is no apparent change in the law concerning unrealized appreciation.[88]

It is important, however, to raise a "caveat." Modern accounting does not favor unrealized appreciation of assets. In the quest for orderly computation of periodic profits and losses, earnings are assigned to the accounting period in which revenue is "realized," *i.e.*, converted into cash or equivalent. A recognition of unrealized appreciation as "revenue" or "earnings" upsets this orderly arrangement because it is premature as a matter of timing. Thus, unrealized appreciation does not belong in earned surplus.[89] If unrealized

82. Cf. Baker and Cary, Cases and Materials on Corporations (3d ed. unabr. 1959), text notes at pp. 1211, 1195.

83. N.Y. Legis. Doc. No. 12, Rev. Supp. 9 (1961).

84. N.Y. Bus. Corp. Law § 717.

85. Assets, other than cash and receivables, are keyed to historical costs rather than estimated market values. Many valuable items, such as favorable executory agreements (including employment contracts with talented personnel), do not normally appear on the balance sheet.

86. The old New York law has often been described as applying a "balance sheet" test for dividends. See, e.g., Baker and Cary, op. cit. supra note 82 at 1196; Lattin and Jennings, Cases and Materials on Corporations 1102-1105 (3d ed. 1959).

87. N.Y. Bus. Corp. Law § 102(a)(6).

88. N.Y. Legis. Doc. No. 12, App. C, 62 (1961).

89. American Institute of Certified Public Accountants, Restatement and Revision

appreciation is placed in capital surplus, and capital surplus is available for dividends, the payment of such dividends may result in a dangerous drain in the financial capital of the corporation.[90] Accounting practice therefore tends to recognize unrealized appreciation only in unusual situations, such as quasi-reorganizations.[91] If it is reasonable to expect that, under the new statute, established accounting and financial usage will be more persuasive to the courts than it has been in the past, the principle of *Randall v. Bailey* may well prove in the future to be applicable to a much smaller number of instances than the cases have heretofore suggested.[92]

Whether this is good or bad depends to a large extent upon one's prejudices. I rather suspect that the affection with which *Randall v. Bailey* is held in the hearts of many corporation lawyers is due, not only to the fact that it provided almost inexhaustible teaching material for Professor Ralph J. Baker, but also to its ringing declaration of judicial independence from accountants, economists, investment analysts, business and other laymen in the interpretation of a statute.[93] On the other hand, Mr. Arthur H. Dean some ten years ago observed that "*Randall v. Bailey* has produced no marked change in the disfavor with which unrealized appreciation is viewed as a source of dividends."[94] A reasonable conclusion is that the new act, if it tends to reduce the amount of dividends paid out of unrealized appreciation of assets (which remains to be seen), will be in tune with prevailing expert opinion.

Disclosure of sources other than earned surplus—More controversial is the requirement that disclosure be made to the shareholders when a dividend is paid from sources other than earned surplus.[95] A number of prominent lawyers have argued that the distinction between earned surplus and other types of surplus is new to the law of the state,[96] and that there is no reason for

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of Accounting Research and Terminology Bulletin (Final ed. 1961) (A.R.B. No. 43) 11, 73.

90. For this reason, a number of statutes permit only share dividends out of revaluation surplus; e.g. Ill. Bus. Corp. Act § 41(c), Mich. Gen. Corp. Act § 480.22, Ohio Rev. Code § 1701.43(B).

91. American Institute of Certified Public Accountants, op. cit. supra note 89 (A.R.B. No. 43) at 47.

92. For example, it is probable that "developed goodwill" would not be acceptable, notwithstanding Hayman v. Morris, 26 N.Y.S.2d 754 (Sup. Ct. 1941).

93. Walter, J., supra note 81 at 179:

> . . . the question is not one of sound economics, or of what is sound business judgment or financial policy or of proper accounting practice, or even what the law ought to be.

94. Dean, Provision for Capital Exhaustion under Changing Price Levels, 65 Harv. L. Rev. 1339, 1343, n. 11 (1952).

95. N.Y. Bus. Corp. Law § 510(a)(2), to be renumbered § 510(c) upon enactment of § 20 of the omnibus bill. "Earned surplus" is defined substantially in accord with standard accounting usage. N.Y. Bus. Corp. Law § 102(a)(6).

96. Note, however, that for many years (1890-1923) the New York corporation law permitted dividends only out of "surplus profits," a concept closer to earned surplus than to capital surplus. This provision first appeared in the N.Y. Stock Corp. Law of 1890 (L. 1890, ch. 564, § 23) and was eliminated by the N.Y. Stock Corp. Law of 1923 (L. 1923, ch. 787). At the time, capital surplus did not have the magnitude or frequency that it has today.

imposing a substantial burden on New York corporations in the absence of cogent evidence that there is something wrong with the present statute.[97]

The enactment of the disclosure requirement is traceable to "the widespread practice of creating large surpluses by the issue of shares with nominal par or stated values."[98] Especially in connection with common shares, the spread between par value and issue price in recent years has tended to be very large.[99] If dividends may be paid out of the capital surplus so created, without appropriate disclosure of the source, the corporation law becomes a natural incubator for more or less genteel Ponzi-type swindles.[100] The obvious radical corrective would be to prohibit altogether any dividends from sources other than earned surplus. From an accounting and financial point of view, this is the logical remedy because the premium paid upon the issue of shares, regardless of its legal label, is part of the capital investment of the shareholders.[101] Much can be said in favor of the imposition of statutory restrictions on distributions out of capital surplus (*e.g.*, permitting payment of dividends on preferred shares out of capital surplus only if there is no earned surplus), rather than the disclosure requirement, on the ground that disclosure is seldom beneficial to the average shareholder.[102] Nevertheless, the scheme of the new act seems to provide a sensible balance of interests.[103] On the one hand it retains the flexibility of the old law with respect to the legality of dividends and other distributions of cash or property out of any surplus. On the other hand it tends to frustrate flagrant fraud upon the shareholder, since he must be given fair warning if his dividend check does not represent what he would normally expect it to be—*i.e.*, a distribution of earnings—but is instead a return of his own or somebody else's capital.[104]

On the technical side, criticism of the new act has been addressed to the difficulties and uncertainties involved in making the required distinction between earned surplus and capital surplus. It is noteworthy that none of the accountants who have testified at the various public hearings have envisaged any

97. Testimony of bar association representatives at public hearing in Albany, February 14, 1962. The disclosure provisions were deemed to be "paternalistic."

98. N.Y. Legis. Doc. No. 12, App. C., 63 (1961).

99. It is a rare occurrence today for common shares to be issued at or near their par value. A random sample of par-value common stocks advertised in the New York Times, taken on Monday, February 19 (pp. 36-37) and Friday, February 23 (p. 47), 1962, shows two issues on the first day with identical 10¢ par values offered at $3.25 and $3.50 per share; on the second day, a conservative issue of $5 par value at $16-7/8 per share, and a somewhat bolder issue of 1¢ par value at $6 per share.

100. Cf. Kehl, Corporate Dividends 69, n. 219 (1941) on Associated Gas & Electric Company case. For a more critical view, see Kessler, The New York Business Corporation Law, 36 St. John's L. Rev. 1, 28-33 (1961).

101. American Institute of Certified Public Accountants, op. cit. supra note 27 (A.T.B. No. 1, 5 para. 66) at 29.

102. Baker and Cary, op. cit. supra note 82 at 1295-1307.

103. As between corporation and shareholder. With respect to creditors, the dwindling protection afforded by nominal par or stated value of shares underscores the importance of the equitable solvency limitation on dividends.

104. It is possible that this information, therefore, may have significance from the viewpoint of taxation of such dividend.

difficulty in complying with this phase of the law. For them, making the distinction between earned and capital surplus is standard practice,[105] regardless of whether or not it is required by law. Since most New York enterprises are likely to use the services of professionally trained accountants, the number of corporations which still mix earned and capital surplus into a single account is probably very small. For such cases, however, the new act provides a simple method of compliance.[106]

With respect to uncertainty, it has been pointed out that there are differences of professional opinion among accountants concerning the effect of specific transactions upon earned surplus; and some doubts have been expressed as to whether corporations will be able to determine the amount of earned surplus at the time of declaring dividends, if this should occur in the middle of an accounting period.[107] Without going into detail on these issues, or on the broader problem posed by the elements of judgment and estimate that are inherent in the accounting process, one may simply note that the new statute contains two exonerating provisions: first, it permits a statement of the approximate effect of the dividend on the surplus accounts if the exact amounts are not determinable;[108] and second, it imposes liability only when there has been a failure of good-faith compliance with the notice provisions.[109]

The liability for failure of compliance with this and similar notice provisions is based on tort and is placed deliberately upon the corporation rather than upon directors or officers.[110] The basis of action is the loss sustained by the shareholder in consequence thereof; corporate liability is apparently intended to provide a readily available defendant to the injured shareholder and at the same time to exonerate innocent officers and directors. If the corporation suffers a loss at the suit of the shareholder, however, it should obviously have the right to proceed against the officers and directors who were at fault.[111] An alternative sanction might have been the imposition of a statutory penalty, but the new law has tried to avoid this method of enforcing its provisions.[112]

105. American Institute of Certified Public Accountants, op. cit. supra note 89 (A.R.B. No. 43) at Ch. 1 (A). Cf. SEC Reg. S-X, Rule 5.02(35), 17 CFR § 210.5-02(35) (Supp. 1961).

106. N.Y. Bus. Corp. Law § 517(1)(A):

> The board of any corporation formed before the effective date of this chapter may determine the amount of the corporation's earned surplus before the declaration of the first dividend after the effective date of this chapter, and such determination if made in good faith shall be conclusive. . . .

107. This last point would not seem to be new. A similar doubt can be raised under the old law with respect to the amount of undifferentiated surplus.

108. N.Y. Bus. Corp. Law § 510(a)(2), to be renumbered § 510(c) by § 20 of the omnibus bill.

109. N.Y. Bus. Corp. Law § 520.

110. N.Y. Legis. Doc. No. 12, Rev. Supp. 33 (1961).

111. Lawyers opposed to the disclosure requirement have proposed two alternatives to emasculate its effectiveness: Permissive waiver in the certificate of incorporation, and elimination of any liability for directors, even if they are at fault. Testimony at public hearing in Albany, February 14, 1962.

112. Compare, e.g., N.Y. Stock Corp. Law § 10 with N.Y. Bus. Corp. Law § 624(a).

The wasting assets provision—Aside from the disclosure requirement, the other major novelty in the dividend law of the new statute is the limited capital impairment permitted in the case of wasting assets corporations, broadly defined.[113] The limitations are: (1) that dividends in excess of surplus may not exceed the portion of the cost of wasting assets that has been recovered through depletion, amortization or sale; and (2) that the remaining net assets at least equal the liquidation preferences of preferred shares.[114]

III

Share Repurchases

The basic pattern of the Business Corporation Law on the subject of share repurchases is similar to that of the Stock Corporation Law, although modified in some details. The old and the new statutes follow generally the same rules that are applicable to cash and property dividends, since in both situations there is a distribution of corporate assets to shareholders.

Related questions are the accounting aspects of share reacquisitions and the provisions governing options and contracts for repurchase of shares.

Fundamental rules—Subject to the equitable solvency limitation, a corporation under the Business Corporation Law may repurchase its shares out of any surplus and, in certain enumerated cases, out of capital.[115] If the shares are repurchased out of capital, they must be cancelled.[116] On the other hand, if the shares are repurchased out of surplus, the directors as a rule have the option of retaining them as treasury shares or of cancelling them at the time of acquisition or at any time thereafter; the exceptions are converted shares and any other shares required by the certificate of incorporation to be cancelled upon reacquisition.[117] Cancelled shares are restored to the status of unissued shares; they need not be eliminated from authorized shares unless their reissue is prohibited by the certificate of incorporation.[118]

Disclosure—If there is a reduction of stated capital as a result of share cancellations,[119] disclosure is required to be made to shareholders in the next financial statement, or in any earlier dividend notice, or in any event within six months.[120] This method of disclosure to shareholders takes the place of

113. The term includes corporations engaged in exploiting natural resources and patents, or formed primarily for the liquidation of specific assets. N.Y. Bus. Corp. Law § 510(a)(1), to be renumbered § 510(b) by § 20 of the omnibus bill.

114. The first limitation is derived from Model Act § 40(b); the second from Del. Code Ann. tit. 8, § 170 (1953).

115. N.Y. Bus. Corp. Law § 513. This follows generally the earlier law of New York except for a new provision—elimination of fractions of shares out of stated capital.

116. N.Y. Bus. Corp. Law § 515(a).

117. N.Y. Bus. Corp. Law § 515(b) and parts of (a).

118. N.Y. Bus. Corp. Law § 515(e). Cf. N.Y. Stock Corp. Law § 21, requiring elimination from authorized shares in the case of dissenters' shares purchased out of capital.

119. No reduction of stated capital results from cancellation of converted shares. N.Y. Bus. Corp. Law § 519(e).

120. N.Y. Bus. Corp. Law § 515(d). The organized bar, which has consistently opposed the disclosure requirement, suggested that if disclosure is required for dividends

the "statement of cancellation" required to be filed for public record under the Model Act[121] or the pseudo-"amendment" required by the Stock Corporation Law for the same purpose.[122] The present language of the new act, however, does not adequately take care of the situation where redeemable shares may be reacquired out of capital over a period of time and thus must be cancelled every day as they are reacquired. The 1962 omnibus amending bill will remedy this fault.[123]

Accounting for share repurchases—In the absence of statutory directions, express or implied, the usual question in accounting for share repurchases is whether the distribution of corporate assets to the shareholder is analogous to dividends or to (partial) liquidation.

The Business Corporation Law follows the dividend analogy for shares purchased out of surplus which do not have to be cancelled upon reacquisition. There is a specific provision that the retention of reacquired shares as treasury shares does not reduce stated capital.[124] Thus the assets spent for reacquisition of treasury shares give rise to a reduction of surplus, as in the case of assets distributed as dividends.

Again, as in the case of dividends, there is no statutory requirement that the amount distributed be charged first to earned surplus, but the statute favors compliance with orthodox accounting procedure in both instances. In the case of dividends, no notice is required if the dividend comes out of earned surplus.[125] In the case of share repurchases, if earned surplus has been applied to the reacquisition, the corporation is permitted to restore to earned surplus, out of the consideration received upon resale of the shares, the amount so applied.[126] The complicated procedure of "surplus restrictions" for treasury shares thus becomes unnecessary.[127]

On the other hand, when repurchased shares are to be cancelled upon reacquisition, the Business Corporation Law provisions would permit accounting for the reacquisition on the "contraction of capital" theory.[128] Upon cancellation of shares, the stated capital is "reduced by the amount of stated capital represented by such shares, which may include the pro rata portion

paid out of other than earned surplus, a similar disclosure to shareholders should be required whenever shares were repurchased. Joint Report of Bar Ass'ns p. 121, § 5.20 The analogy does not hold, because there is no implied representation to the remaining shareholders; the true parallel here is public disclosure of other reductions of stated capital, conversion of shares and similar capital readjustments.

121. Model Act § 61.

122. N.Y. Stock Corp. Law §§ 29, 27(5), 28(2).

123. Omnibus bill § 24.

124. N.Y. Bus. Corp. Law § 515(c).

125. N.Y. Bus. Corp. Law § 510, discussed supra p. 467.

126. N.Y. Bus. Corp. Law § 517(a)(5). However, no restoration of earned surplus can be made if the treasury shares are cancelled. The resulting surplus is capital surplus under § 517(a)(3).

127. See de Capriles and McAniff, The Financial Provisions of the New (1961) New York Business Corporation Law, 36 N.Y.U. L. Rev. 1239, 1261 (1961).

128. See American Accounting Ass'n, Accounting and Reporting Standards for Corporate Financial Statements 7 (1957).

of any surplus that may have been transferred to stated capital and not allocated to any designated class or series of shares."[129] Since there is no requirement that the excess of cost over stated capital be deducted entirely from earned surplus, it is permissible upon cancellation to reduce capital surplus by the amount allocable to the cancelled shares. The analogy to partial liquidation is especially persuasive in the case of the repurchase of redeemable shares out of stated capital.[130]

Options and contracts to repurchase—The Business Corporation Law develops more fully than does the Stock Corporation law the subject of redeemable shares,[131] including a provision for redeemable common shares if at the time of issue and redemption there is another class of common shares not subject to redemption.[132] The new statute makes it clear that redeemable shares are ordinarily "callable" shares, since the option to redeem belongs to the corporation.[133] With one exception, corporations may not issue shares which purport to give the holder the option to compel redemption by the corporation.[134] The rationale of the rule appears to be that such securities, if compulsory redemption is enforceable,[135] are really a type of bond and should be labeled as such. An exception is made only for shares of open-end investment companies subject to federal regulation.[136]

It follows that in ordinary corporations a shareholder may obtain the right to compel the corporation to buy his shares, within the limits permitted by the solvency and surplus rules, only by contract. The Business Corporation Law has given statutory recognition to agreements for purchase by a corporation of its own shares[137] and, in doing so, has removed the doubts cast by the *Topken* case[138] on the availability of the remedy of specific performance.

Two final points should be mentioned: (1) There is a protective provision for holders of redeemable shares in that the corporation may not pay more than the redemption when it buys redeemable shares (other than upon a call for redemption) during the period of redeemability.[139] (2) Since reacquired shares may be cancelled by the directors without shareholder approval, and the resulting surplus is available for additional share repurchases,

129. N.Y. Bus. Corp. Law § 515(d).
130. The reason for permitting repurchase of redeemable share out of capital is that such shares are deemed to be temporary by the terms of their creation.
131. N.Y. Legis. Doc. No. 12, App. C, 62 (1961).
132. N.Y. Bus. Corp. Law § 512(c).
133. N.Y. Bus. Corp. Law § 512(a).
134. N.Y. Bus. Corp. Law § 512(b).
135. In the absence of specific statutory authority, compulsory redemption is probably not enforceable. See Dewing, Financial Policy of Corporations 154, n. aaa (5th ed. 1953).
136. N.Y. Bus. Corp. Law § 512(b).
137. N.Y. Bus. Corp. Law § 514. The text of this section is revised by § 24 of the omnibus amending bill.
138. Topken, Loring & Schwartz, Inc. v. Schwartz, 249 N.Y. 206, 163 N.E. 735 (1928).
139. N.Y. Bus. Corp. Law § 513(c).

it is possible for a corporation that has enough surplus to buy back one of its shares to repurchase as many shares as its financial resources will permit under the equitable solvency limitation.[140]

IV

Share Distributions and Reclassifications

The Business Corporation Law[141] codifies the case law governing stock dividends, stock splits, and related corporate action, with a few variations and additions. Since these transactions do not involve disbursements of assets, they cannot threaten corporate solvency; but they normally affect one or more of the accounts reflecting the ownership interest in the corporation and thus may give rise to problems of appropriate disclosure to the shareholders. The new act contains an anti-dilution provision,[142] and another authorizing share distributions upon treasury shares;[143] neither is to be found in the existing precedents.

Stock dividends and splits—The Business Corporation Law deliberately avoids use of the term "stock dividend" because of the "conflict between the trust cases and the views of the financial community."[144] The traditional case law tends to classify a share distribution to shareholders as a stock dividend if there is a transfer from surplus to stated capital equal to the par value of the shares distributed. The term stock split is limited to situations in which additional shares are created without any effect on the surplus or stated capital accounts; all that happens is that the same stated capital is represented by a larger number of shares due to a proportionate decrease in the par or stated value of each share. The financial community, on the other hand, often speaks of a "stock split effected in the form of a stock dividend,"[145] which would be unintelligibly confusing under traditional legal distinctions.

The case law developed in a period when most "surplus" represented accumulated earnings and "par value" was a reasonable approximation of the capital investment represented by each share. Thus "stock dividends" were in substance a capitalization of earnings with the same effect *as if* a cash dividend had been paid and the shareholder had reinvested the dividend in additional shares. This is still the popular conception of stock dividends.[146]

The source of modern confusion is again the widespread practice of issuing shares at nominal par or stated values far below the amount of invest-

140. Quaere, whether in an action for specific performance a corporation could be compelled to cancel reacquired shares to produce surplus out of which to buy shares within the solvency limitation.

141. N.Y. Bus. Corp. Law § 511. "This section is new to the statutory law of New York, but in large part codifies existing case law." N.Y. Legis. Doc. No. 12, Rev. Supp. 29 (1961).

142. N.Y. Bus. Corp. Law § 511(a)(3).

143. N.Y. Bus. Corp. Law § 511(b).

144. N.Y. Legis. Doc. No. 12, Rev. Supp. 20 (1961).

145. N.Y. Stock Exchange, Company Manual, § A-14, p. A-257 (1959).

146. Id. at § A-13, p. A-235 (1955).

ment they represent, so that it becomes imperative to make a distinction between the "capital surplus" so created and the surplus that represents accumulated earnings. The old-fashioned "stock dividend," in the context of modern finance, must *a fortiori* involve a transfer out of earned surplus of an amount equal to the fair or market value of the shares, an amount normally far in excess of the par or stated value of the shares. The excess goes into "capital surplus," which from the financial viewpoint is invested capital, akin to stated capital and not to earned surplus. If a share distributed to shareholders is supported by the transfer of only the nominal par or stated value from earned surplus to stated capital, or if the transfer is made from capital surplus to stated capital, the effect is for most purposes similar to that of the traditional stock split—substantially the same amount of invested capital broken up into a larger number of shares.[147]

These modern developments are further complicated by the growing practice of using treasury shares for these distributions. Technically under the case law it is not essential to make *any* transfer from surplus to stated capital because the treasury shares are already part of the stated capital. The nature of the distribution then depends on whether an appropriate transfer is made from earned surplus to capital surplus.

The Business Corporation Law of course permits accounting for true stock dividends in accordance with preferred professional practice[148] but does not attempt to compel such accounting. It does specify that the consideration for the issue of new shares is the transfer of surplus (of either kind) to stated capital;[149] but this provision only corrects an ancient inconsistency between the letter of the statute and long-accepted practice.[150] As in the case of cash dividends, the new act relies upon appropriate disclosure as a technique to avoid misleading the shareholders concerning the nature of a particular corporate action.

Disclosure—The basic reason for requiring disclosure is the popular conception of the "stock dividend" as a "distribution" of earnings which have been automatically reinvested in the shares received by the shareholder. If the shares distributed in effect constitute a stock split from the financial viewpoint, there is an element of harmful deception, even if there has been a transfer from surplus to stated capital for the nominal par or stated value of such shares.[151]

147. Cf. American Institute of Certified Public Accountants, op. cit. supra note 89 (A.R.B. No. 43) at 51-53 (1953).

148. Cf. N.Y. Bus. Corp. Law § 511(e):

> Nothing in this section shall prevent a corporation from making supplementary transfers from earned surplus to stated capital or capital surplus in connection with share distributions or reclassifications.

149. N.Y. Bus. Corp. Law § 504(f).

150. Cf. N.Y. Stock Corp. Law § 69, which does not expressly recognize transfers of surplus as consideration for shares; the case law has done so since Williams v. Western Union Tel. Co., 93 N.Y. 162 (1883).

151. N.Y. Legis. Doc. No. 12, App. C, 63 (1961).

An earlier version of the Business Corporation Law[152] was drafted around the idea that the label "stock dividend" should be prohibited except for share distributions that were supported by a transfer out of earned surplus of an amount equal to the fair or market value of the shares. For a variety of reasons, including the possibility of unpredictable repercussions in the law of trusts and of conflict with one section with the Personal Property Law,[153] the proposal was dropped from subsequent drafts.

The statute now requires that every distribution of shares to shareholders shall be accompanied by a statement of the effect of such distribution upon the stated capital, earned surplus and capital surplus of the corporation.[154] The shareholder is expected to draw his own conclusions.

This pattern of disclosure is similar to the notice required to accompany dividends made from sources other than earned surplus. There seems to be an omission in the disclosure machinery, however, with respect to stock splits and reclassifications or combinations of shares, which may not involve share distributions, and yet may have a direct effect upon the ownership accounts of the corporation similar to that involved in share cancellations and conversions.[155]

Other new provisions—A final word should be said about the two new provisions in this area of the law. The anti-dilution section specifies that share distributions may be made only to holders of the same class or series of shares unless the certificate of incorporation permits distribution to holders of another class, or unless consent is obtained from the holders of a majority of the outstanding shares of the class or series to be distributed.[156]

The section authorizing a corporation, upon distribution of unissued shares to the holders of any class of outstanding shares, to make at its option an equivalent distribution upon treasury shares of the same class,[157] is said to be valuable when treasury shares are being held to meet outstanding options or conversion privileges.

CONCLUSION

From the foregoing analysis it will be evident that the disclosure requirements in the financial provisions of the Business Corporation Law have elicited the greatest difference of opinion. For critics who favor stricter regulation of corporate management, the disclosure provisions appear too permissive; they will not prevent corporate action that may be harmful to share-

152. Proposed N.Y. Bus. Corp. Law, Senate Int. 3124, Senate Pr. 3316, 183d Sess. (1960).
153. N.Y. Pers. Prop. Law § 17-a.
154. N.Y. Bus. Corp. Law § 511(f).
155. Section 21 of the omnibus bill will correct this omission by adding a new section (g) to N.Y. Bus. Corp. Law § 511.
156. N.Y. Bus. Corp. Law § 511(a)(3).
157. N.Y. Bus. Corp. Law § 511(b).

holders or creditors.[158] For critics who regard shareholders as mere contributors of capital funds not interested in the technical nature of dividends, share distributions, and similar matters, the disclosure provisions appear to impose an indefensible burden upon corporate management.[159]

The preceding discussion will also make it clear that I personally believe the disclosure provisions have a rational basis addressed to the solution of well-defined problems with a minimum of prohibitions. Accordingly, it is desirable to summarize in proper perspective the various disclosure situations and the type of burden that they impose upon corporate management.

(1) Management is required to send a notice to the shareholders accompanying any dividend paid from sources other than earned surplus. For the reasons previously given, there is no real technical problem in determining the amount of earned surplus. Thus, the giving of notice involves only an appropriate statement on a slip of paper accompanying the dividend check; or perhaps a statement on the check itself. Even this can be avoided if the directors decide to pay dividends out of earned surplus only—which as a rule is not a bad idea.

(2) Management is also required to send a notice accompanying any share distribution to shareholders. Again, this is not technically difficult or burdensome. Some explanation usually accompanies the certificate for the new shares, and all that is involved in complying with the disclosure requirement is some attention to the content of that explanation. The frequency with which this is needed depends upon how often a corporation makes share distributions to its shareholders. Most of the middle-sized and small corporations do so only at rare intervals.

(3) Management is also required to give notice (directly to shareholders, rather than by public filing) of reductions of capital, share conversions, and eliminations of deficits in the earned surplus accounts in the next financial statement, or in any earlier dividend or share distribution notice, and in any event within six months. None of these corporate operations occur with any frequency. Special arrangements for notifying shareholders need be made only if there is no communication with shareholders for a period of six months after what is a most unusual occurrence in the life of the corporation.

Naturally one cannot insist that a corporation pay dividends or make share distributions at frequent intervals. But every corporation can readily make (and perhaps *should* make) periodic financial reports to its shareholders, which will ordinarily eliminate the need for separate communications to shareholders with respect to these extraordinary events. If the existence of these disclosure requirements will promote regular, perhaps quarterly, financial statements to shareholders, which are *not* presently required by the new

158. See Kessler, The New York Business Corporation Law, 36 St. John's L. Rev. 1, 33-34 (1961).

159. Testimony of Mr. Sinclair Hatch at public hearing in Albany, February 14, 1962.

act,[160] I would regard this as a bonus and a definite "plus" factor in the total evaluation of the financial provisions of the Business Corporation Law.

However, regular financial statements alone, without the specific information required to be disclosed under the Business Corporation Law, do not by themselves offer a satisfactory substitute for the disclosure provisions. Even if each successive statement contained a breakdown of earned and capital surplus, the amount of the changes would not be readily determinable without comparative figures, and an understanding of the changes by most shareholders would require explanation in a manner approximating that implied in the disclosure provisions.

In summary, it seems to me that the financial provisions of the Business Corporation Law do not unduly interfere with the freedom of management to manage. They do, however, insist that this be a responsible freedom, with periodic disclosure to shareholders; and this, I believe, is a reasonable and desirable feature of a modern corporation law.[161]

160. The present text in effect requires a corporation to furnish financial statements to a shareholder only if such statements have already been distributed to other shareholders or made available to the public. N.Y. Bus. Corp. Law § 624(e). The omnibus bill Section 41 requires financial statements to be furnished upon request to holders of five per cent or more of any class of outstanding shares, or to any person who has been a shareholder for six months.

161. Regardless of the merits of the celebrated Berle-Dodd controversy [Dodd, For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145 (1938); Berle, For Whom Corporate Managers Are Trustees: A Note, 45 Harv. L. Rev. 1365 (1938)], it should be evident that, in the present state of our law, effective accountability of management to shareholders for the administration of economic enterprises is the only practical alternative to ultimate bureaucratic control.